

FOUNDATIONS TO BUILD ON

by

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I think it is great that you are taking time to consider, "Foundations To Build On." The teaching of students, cooperative employees, cooperative directors, cooperative members and the public about cooperatives as one of the ways of doing business in the United States has been neglected for too long. The common practice of teaching members, employees and the public about cooperatives is for ongoing firms to say, "We are a cooperative - what we do is the way it is, the way cooperatives operates - and anyone who teaches anything different than the way we do it is anti-cooperative." We have, in fact, members of cooperatives who don't know that they are the owners of the cooperative and thus abdicate their rights and responsibilities as members. An article in Barron's July 11, 1979, page 9, entitled, "How Equitable? Mutual Insurance Companies Have Begun to Change Their Ways," the president and chief executive officer of a large Mutual Insurance Company is quoted as saying, "...Ownership is a baffling legal question... It seems appropriate for management to behave as though the policyholders are owners." We have all heard members of cooperatives say that they should not have to pay the IRS taxes for "the" cooperative, and for years we have heard 'it just costs too much to have an annual meeting every year or it just costs too much in postage and bookkeeping for the firm to return its profits as patronage refunds to members.' We also hear the statement, 'cooperatives are like any other business or, if cooperatives are to compete, the cooperative principles must change.' So, what is a cooperative? It is one of the four ways of doing business that the people of the United States - society - has permitted to operate in our free competitive economy.

In the United States we have a free competitive capitalistic economy. Our free competitive economic system is essentially a capitalistic system based on private enterprise. Private enterprise means that individuals, not government, own the firms or businesses that produce and market goods and services. Of course, I must add that in the United States we do not have a purely capitalistic system, nor a purely private enterprise system. Our government does own some of our resources and government has established regulations. But ours is still the best in the world.

As U. S. citizens you and I have the right of private property. In the United States an individual has the right to acquire, to use, to accumulate and to dispose of things of value. An important feature of this right of private property is that a person can acquire and use property as he or she pleases but within the rules established by society. Like our freedom, or our cooperative membership, we often get too accustomed to this privilege of the right of private property and become apathetic.

Presented at the 51st National Institute on Cooperative Education of the American Institute of Cooperation, University of Missouri, Columbia, Missouri, August 7, 1979.

People use their private property to generate more property and this has been an important factor for the high standard of living we have in the United States. People invest their private property to make a profit. The incentive to invest lies in the chance of getting a return on the investment.

Society has decided that we can have certain kinds of businesses operating in our free competitive economy. They are: sole proprietorship, partnership, investor corporation and cooperative corporation.

To briefly describe the four ways of doing business -- A sole proprietorship is a business owned and managed by one person. The partnership is a business where two or more persons are co-owners of a business for profit. An investor corporation is a business where people invest their money in anticipation of receiving a return (profit) on their investment. The cooperative corporation is an extension of its members' business - a cooperative is a firm carrying on the business of its members. In a cooperative persons do not benefit by receiving a return on their investment but benefit from the value added to the goods and services resulting from their primary business, such as farming, thus increasing their profits from their farming operation.

Society has established special rules for each of these four kinds of businesses to follow. They are all four 'businesses' that operate in our economic system but each is different from the other and for any one type to be successful those who operate the business must know the rules society has established for that particular type of business. It is much like a ball game.

For example, there are many games played with a round ball: baseball, softball, tennis, golf, basketball, handball and volleyball. Each round ball game has its own rules and goals and the player must know the rules and how to score if he is to play the game successfully. The same is true for businesses. Directors, management and employees of cooperatives must not only know what a cooperative is but they must also know and understand the rules under which it is to be operated (State Statutes, Articles of Incorporation, Bylaws, marketing or membership agreement).

The several dictionary definitions of a 'cooperative' can be summarized as: an organization owned collectively by members who share in its economic benefits.

Several years ago the U. S. Department of Agriculture made a very intensive effort to better define a cooperative business. The definition developed by the Farmer Cooperative Service, now ESCS, is:

"A cooperative is a voluntary contractual organization of persons having a mutual ownership interest in providing themselves needed service(s) on a non-profit basis. It is usually organized as a legal entity to accomplish an economic objective through joint participation of its members. In a cooperative the investment and operation risks, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative's services. A cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the cooperative."

The word "mutual" is synonymous with "cooperation." Both terms can be defined as common or joint effort and get right to the purpose for which cooperatives are formed--the mutual benefit of the members.

Principles are fundamental laws and concepts are ideas of what a thing in general should be. The basic principles of cooperatives were not improvised, but like all principles they were discovered, observed and tested. To qualify as a principle, a concept must have been in existence always or for a very long time.

For well over a century, writers have been recording the history of the cooperative way of doing business. Much emphasis has been placed on the evolution of principles of cooperatives. The cooperative principles were discovered being used by early cooperatives that evolved locally and independently of one another in many countries, including England, Scotland, Germany, France, Scandinavia and then these basic cooperative principles were later adapted to the free competitive economy of the United States.

There are three basic cooperative principles on which there is virtually unanimous agreement. If a firm is a cooperative it must meet these three basic principles. The three basic principles of cooperation are:

1. DEMOCRATIC CONTROL -- the association is owned and controlled democratically by the member patrons.
2. OPERATION AT COST -- the association is operated on a non-profit or cost basis for its member-users rather than being operated on a profit basis for its investors (net earnings are distributed on a patronage basis, not as returns on investment).
3. LIMITED RETURNS ON CAPITAL -- Only limited returns (comparable to modest interest rates) are paid on ownership capital (capital is subordinated to member usage for purposes of sharing monetary gains).

There are two other cooperative principles that some people add to the three listed above to decide whether or not the firm is a cooperative. They are: (4) member ownership of the firm, and (5) duty to educate about the cooperatives.

A cooperative is a firm carrying on the business of its members. The cooperative acts as a type of conduit in doing the members' business. The cooperative's transactions are really the members' transactions. Members do not buy from their cooperative or sell to their cooperative--members buy through and sell through their cooperative.

The cooperative plays the role of an agency, trust, fiduciary or conduit in conducting the members' business.^{1/} The fact and theory merge in that the cooperative is not entitled to entity ownership of the results (margins or profits) of the business. The results of the cooperative's business (sometimes referred to as value added) belong to the members on the basis of their patronage--as set forth in a pre-existing legal obligation (Articles of Incorporation, Bylaws or membership application or contract).

^{1/} Income Taxes - Farmer's Cooperatives - Some Concepts, John W. Holt, Director Corporation Tax Division, Internal Revenue Service, The Cooperative Accountant, Spring 1976, pages 2-14.

Yes, a cooperative can take title to the goods it markets and the supplies it purchases; it can also pass such title in a sale or exchange and take legal title to the proceeds. However, such legal title is for the benefit of the members--who have a pre-existing legal right to any margins or profits (the amounts remaining after costs and expenses) generated by the members patronage. Thus, a cooperative never has the type of possessory ownership we usually attribute to that term--the cooperative board of directors is not free to dispose of the cooperative's profits or margins as are the directors of investor corporations. The cooperative's margins or profits belong to the patrons on the basis of their patronage as they are, in fact, either over charges made by the cooperative to the members for items they have purchased through the cooperative or under payments made by the cooperative to the members for products the members sold through their cooperative.

However, when a firm takes title to patronage margins or losses (profits or losses) in its own right--and the cooperative pays IRS taxes on these margins--it passes beyond the cooperative principle of operation at cost and thus becomes an investor corporation, operating for the benefit of investors not members, it is no longer a cooperative.

Principles are unchanging. Cooperative principles do not change. It is men and organizations that change over time, not principles. Cooperative business firms may undergo such marked changes, either in operations or structure, that they must of necessity, operate under a different set of principles to achieve their objective, thus they are no longer a cooperative or a mutual.

Farmers invest in farms to make a profit; they use their cooperative to assist them in increasing their profit from their farming operation.

Agricultural cooperatives are one of the many tools farmers have to assist them in efficiently producing and marketing food and fiber. The agricultural cooperative is a 'tool' of modern agriculture comparable to the 'farm tractor'. Each of these tools requires skilled operators, sufficient energy to operate, good maintenance to be in top working condition, and must be fitted for the job.

Many of our agricultural cooperatives started in the 1920s and 30s, about the time "Fordson" tractor was a tool of modern agriculture. As the demands of agriculture outgrew the capabilities of the "Fordson", cooperatives also had to change, adjust and grow to continue being an effective tool for modern agriculture.

The old 1923 Fordson had the same basics that are found in today's modern farm tractor. The old and the new tractors each have wheels, engine, transmission, steering wheel, and seat; but the engineers have built and improved today's tractors using the same basics to serve today's farmers. The same is true for agricultural cooperatives. The same basic cooperative principles that were required in our cooperatives in the 1920s and 30s are required of today's cooperatives. Like the tractor, it has been necessary for agricultural cooperatives to adjust, change and grow in order to be an effective tool for modern farmers. Agricultural cooperatives still must have the three basic principles: (1) democratic control (people control rather than dollars), (2) limited interest on equity capital (so the margins or profits of the cooperative will be returned to the user rather than the investor), and (3) operations at cost (which means

that cooperatives price their services and/or products competitively and at the end of the business year if the cooperative has margins or profits, they will be refunded to those who patronize the cooperative on a patronage basis or if it has not charged enough margin to cover the costs of operation, the users will be asked to pay their share of the loss so that each year their cooperative breaks even). Thus, the cooperative is a conduit that moves the member's goods, services and products through the marketing channel, returning to the member the value added to these good, services and products.

Today's agricultural cooperatives like the tractor and other farm tools are often larger and constructed to serve today's needs. As tractors took on more of the farm work, they required more fuel. As cooperatives take on more marketing tasks and services, they require more capital. As tractors and cooperatives become more sophisticated, they require more skilled operators.

Today's agricultural cooperative and tractor are each more effective and sophisticated tools than the 1920 or 1930 models. The operators of each tool must know its capabilities and how best to employ it. The farmer must keep his tractor and his cooperative in top performance condition if it is to serve him efficiently.

The operators of the cooperative are - the board of directors and they must know the cooperative principles as well as the capabilities and limitations of their cooperative. Like the tractor operator, directors must be trained to perform their tasks in a responsible manner.

Some farmers may prefer to farm without their cooperative just as some may prefer to farm without a tractor. This may be because they don't understand how they can use their cooperative effectively to increase the profits of their farming operation.

Many of our cooperatives were organized to provide services that were not or would not be available otherwise. (Farm supply, marketing, Rural Electric, Farm Credit, artificial insemination.)

Cooperatives are usually incorporated under the laws of the state in which they have their main office. However, Production Credit Associations, Federal Land Banks and Federal Savings and Loan have federal charters. All cooperatives have bylaws or codes of regulations and articles of incorporation that set forth their mission and rules for membership and operation. Members elect a board of directors to manage their cooperative. The board of directors makes general policies and hires a manager. The manager is responsible to the board for the day-to-day business of the cooperative.

President Abraham Lincoln in his second annual message to Congress on December 1, 1862, answered critics of some of the changes he proposed with an observation that went something like this: "The dogmas of the quiet past are inadequate to the stormy present. The occasion is piled high with difficulty and we must rise to the occasion. As our case is new we must think and act anew----".

Dogma means that which is held as opinion.

Our case is new. Cooperatives and all types of business are operating in a new economic climate or "ball game". There is no cooperative director of the past or present that ever managed a cooperative in an economic, social or political climate such as agricultural cooperatives are operating in today.

Today's cooperative director must know what a cooperative is and how it is unique or differs from the other three ways of doing business in our competitive economy. Today's cooperative directors must know the laws, rules and regulations under which the cooperative operates and they must not only know their responsibilities as a cooperative director but discharge these responsibilities with dispatch and in a professional manner.

Most of our academic training was based on investor-oriented corporations. There are many examples of cooperative directors and cooperative employees trained in investor corporate law, investor corporate finance, investor corporate planning, etc., attempting to direct and manage a cooperative the same as an investor corporation business and not following the cooperative principles. Many of these sincere and well meaning but misdirected efforts have resulted in disaster to the individuals and the cooperative and its members because they were not playing in the right ball game, thus the unfavorable press and unfavorable attitude toward cooperatives by the cooperative members as well as employees of IRS, SEC, Justice, etc. Yes, cooperatives must be operated with many of the same management and business principles as other types of businesses but within the unique characteristics of cooperatives. Once the member, director, management, and employee understands which game they are playing--in your case the cooperative corporation--they must know and understand the rules.

I would not be very successful playing tennis with a golf ball and baseball bat or playing golf with a tennis racket and a volleyball. The same goes for farmers who try to manage their cooperative as if it were not a cooperative business.

We have brought on many of the cooperative's 'dogmas' ourselves. First, because we have neglected the cooperative principle, 'duty to educate about cooperatives as a way of doing business' - as a result some of the common 'dogmas' we must overcome are:

Cooperatives sell products cheaper than other businesses.

Cooperatives are exempt from taxation.

Cooperatives are exempt from antitrust.

Cooperatives have open membership.

Cooperatives are like any other business.

It's not economical to return the profits of a cooperative to the members.

It seems appropriate for management to behave as though the policyholders (members) are the owners.

Foundations to Build on. Cooperatives as one of the four ways of doing business in our free competitive capitalistic economy have as their foundation the three basic cooperative principles - operations at cost, democratic control and limited return on equity capital and two supplemental foundation blocks - member ownership and duty to educate about the cooperative. Upon this cooperative foundation you have built a tremendous enterprise - the local cooperative you own, the regional cooperative owned by your local - the multiregional owned by the regional. Take time to add up the total investment you have in your cooperative - then you will realize how valuable it is to you that your local cooperative maintain a sound foundation by following the Cooperative Principles.